European Stability Mechanism

BOARD OF AUDITORS

Annual Report to the Board of Governors

for the period from 8 October 2012 (date of inauguration)

to 31 December 2012

1. Introduction

The Board of Auditors of the European Stability Mechanism (ESM) was set up pursuant to Article 30 of the Treaty establishing the ESM (ESM Treaty) and Article 24 of the ESM By-Laws. The Board of Auditors is independent from the Board of Directors and its members are appointed directly by the Board of Governors.

The Board of Auditors carries out independent audits, inspects the ESM accounts[1] and monitors and reviews the ESM's internal and external audit processes and results[2].

This report, which is addressed to the Board of Governors in accordance with Article 24(6) of the ESM By-Laws, provides information on the audit work of the Board of Auditors, its audit findings in relation to the ESM financial statements and its conclusions and recommendations for the period from 8 October 2012 (the date of inauguration) to 31 December 2012. The report will also be made available to the national parliaments and supreme audit institutions of the ESM Members, as well as the European Court of Auditors and the European Parliament[3].

The members of the Board of Auditors were appointed by the Board of Governors on 8 October 2012 as follows:

- Mr Harald Noack, nominated by the European Court of Auditors
- Mr Marc Gengler, nominated by the Supreme Audit Institution of the Grand Duchy of Luxembourg
- Mr Ulrich Graf, nominated by the Supreme Audit Institution of the Federal Republic of Germany
- Ms Katarína Kaszasová, upon the proposal of the Chairman of the Board of Governors
- Mr Jules Muis, upon the proposal of the Chairman of the Board of Governors

The Board of Auditors elected Mr Harald Noack as its Chairman and Ms Katarína Kaszasová as its Vice-Chair. The members of the Board of Auditors were appointed for a non-renewable term of three years, except for Ms Kaszasová and Mr Graf, who were appointed, their names having been drawn by lot, for a non-renewable term of four years to ensure continuity of the work of the Board.

The members of the Board of Auditors have undertaken, at the time of their appointment and during the performance of their duties, to avoid all conflicts of interest and refrain from any action incompatible with those duties. The members of the Board of Auditors act independently and have not sought or taken instructions from the ESM governing bodies, the ESM Members or any other public or private body[4].

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1 Article 30(3) of the ESM Treaty.
2 Article 24(4) of the ESM By-Laws.
3 Article 24(6) of the ESM By-Laws.
4 In accordance with Article 30(2) of the ESM Treaty and Article 24(9) of the ESM By-Laws.

2. Activities of the Board of Auditors

2.1. Meetings

The Board of Auditors held three meetings in the period from 8 October 2012 to 31 December 2012. As a rule, the members of the Board of Auditors attend monthly meetings at the ESM premises; however, the meeting in December was held as a conference call.

During its meetings, the Board of Auditors received regular updates on the activities of the ESM and the ESM governing bodies, attended presentations by management on specific topics requested by the Board of Auditors (e.g. economics and policy strategy, asset and liability management) and met with the external auditors and with representatives of the European Investment Bank who were responsible for the provision of outsourced accounting services to the ESM.

2.2 Scope

The Board of Auditors has:

- performed limited review procedures in accordance with Article 30(3) of the ESM Treaty. Among other things, it has reviewed the accounting and reporting system, procurement policies, service-level agreements and risk-management policies, and made a top-down preliminary assessment of the financial assistance for Spanish banks;

- reviewed the ESM financial statements for the period from 8 October 2012 (date of inauguration) to 31 December 2012, which were drawn up and adopted by the Board of Directors on 21 March 2013;

- noted that, in accordance with the aforementioned financial statements, the balance sheet totals as at 31 December 2012 were EUR 740 billion, consisting mainly of loans and advances to euro area Member states (EUR 39 billion), subscribed capital called but not paid (EUR 47 billion) and subscribed ("authorised" according to Article 8 of the ESM Treaty) capital not yet called and unpaid (EUR 620 billion). Own funds amounted to a total of EUR 700 billion and liabilities were mainly composed of debts evidenced by certificates (EUR 39 billion). There was a net loss for the financial year of EUR 0,5 million, this mainly being the balance of interest receivable and similar income (EUR 16 million), interest payable and similar charges (EUR 4 million), net profit on financial operations (EUR 1 million) and general administrative costs (EUR 14 million);

- monitored and reviewed the external audit processes performed by PricewaterhouseCoopers, *Société coopérative*, Luxembourg (PwC). On 8 October 2012 PwC was appointed by the Board of Governors to carry out a statutory audit of the financial statements of the ESM as of and for the year ending 31 December 2012 in accordance with the International Standards on Auditing as adopted for Luxembourg by the *Commission de Surveillance du Secteur Financier* (CSSF), the provisions of Luxembourgish legislation, the professional standards adopted by the CSSF and the professional standards issued by Luxembourg's *Institut des Réviseurs d'Entreprises*;

- noted that PwC issued an unqualified auditor's report on 21 March 2013 stating that "*the financial statements give a true and fair view of the financial position of European Stability Mechanism as of 31 December 2012, and of the results of its operations and its cash flows for the period from 8 October 2012 (date of inauguration) to 31 December 2012 in accordance with the general principles of the Directives*";

- met regularly with the ESM Managing Director and other members of the Management Board, including the Secretary General, the Head of Corporate Governance and Internal Policies, the Head of Finance and Control and the Operational Risk Officer, and with other members of ESM management, to discuss relevant issues and developments;

- requested and received a number of written representations from members of the ESM Management Board concerning issues of oversight interest (the role of the ESM and its global partners, an explanation of the issue and repurchase process, application of the EU public procurement directive, the appointment of the external auditor and a presentation of the ESM financial statements).

3. Findings

3.1 Financial statements

In accordance with Article 23(2)(d) of the By-Laws, the Board of Auditors has issued a separate report on the financial statements, in which it concludes:

"*Having examined the start-up phase of the ESM, the Board of Auditors observes, as detailed in its annual report prepared in accordance with Article 24(6), that the institution is still evolving and faces considerable challenges and work in progress as regards establishing suitable internal, operational and managerial controls; and notes, to the best of its judgement, that no other material matters have come to its attention that would prevent it from recommending that the Board of Governors approve the ESM financial statements for the period from 8 October 2012 (date of inauguration) to 31 December 2012.*"

3.2 External audit

Article 29 of the ESM Treaty provides as follows: "*The accounts of the ESM shall be audited by independent external auditors approved by the Board of Governors and responsible for certifying the annual financial statements*".

The ESM financial statements for the period from 8 October 2012 (date of inauguration) to 31 December 2012 were audited by PwC, which was appointed as "réviseur d´entreprises agréé" (certified auditor) by the ESM Board of Governors on 8 October 2012. The engagement letter was signed by the ESM representatives on 4 February 2013. Under the terms of the engagement, PwC was to carry out a statutory audit of the financial statements of the ESM as of and for the year ending 31 December 2012 in accordance with the International Standards on Auditing as adopted for Luxembourg by the CSSF, the provisions of Luxembourgish legislation, the professional standards adopted by the CSSF

and the professional standards issued by Luxembourg's *Institut des Réviseurs d'Entreprises*. PwC issued an unqualified auditor's report on 21 March 2013 stating that "*the financial statements give a true and fair view of the financial position of European Stability Mechanism as of 31 December 2012, and of the results of its operations and its cash flows for the period from 8 October 2012 (date of inauguration) to 31 December 2012 in accordance with the general principles of the Directives*".

Article 24(4) of the By-Laws provides that the Board of Auditors "*shall monitor and review the ESM's internal and external audit processes and their results*".

The Board of Auditors would like to bring the following matters to the Board of Governors' attention.

- During the planning phase, PwC determined that the areas of lending and funding, the recognition of other revenue/expenditure and the calculation of interest income/expenditure were audit risks, and adjusted its audit approach accordingly.
- PwC noted that internal controls were not yet fully operational as at 31 December 2012 and therefore applied an audit approach based on full substantive testing. A fully fledged internal control and governance model taking into account the "three lines of defence" approach should be built up.
- PwC confirmed that, as at 31 December 2012, there were no material issues regarding the balance sheet, inherent risks and management controls of those risks or the effect of estimates on the accounts.
- PwC also confirmed that no significant uncorrected misstatements had come to light.
- PwC concluded that, as at 31 December 2012, no impairment of loans was required.
- PwC informed us that it had good working relations with ESM management, with no areas of disagreement.
- PwC also concluded that the accounting system and organisational arrangements were not yet appropriate having regard to the nature and scale of the ESM's business, and therefore the ESM management should continue to strive for full implementation in these areas in order to ensure independent accounting proofing and reconciliation as well as a stronger financial control function for monitoring the statutory and management accounts.
- PwC was appointed by the Board of Governors without a proper tendering procedure. Although this decision seems to have been dictated by urgency and practicality in view of PwC's engagement as the auditors for the European Financial Stability Facility (EFSF), the Board of Auditors recommends that the audit of the financial statements as at 31 December 2013 and in all future years be put out to tender in accordance with EU legislation.
- Under the terms of the current engagement with PwC, the Board of Auditors has no access to the external auditor's documentation or to the organisations providing outsourced services. The Board of Auditors recommends that access be guaranteed to their documentation for the audit of the financial statements as at 31 December 2013 and in all future years.

3.3 Internal audit

Article 28 of the ESM Treaty provides as follows: "*An internal audit function shall be established according to international standards*".

The ESM decided to create a one-man internal audit department using an internal auditor from the EFSF with several years' experience.

Article 24(4) of the By-Laws provides that the Board of Auditors "*shall monitor and review the ESM's internal and external audit processes and their results*".

The Board of Auditors met the designated internal auditor several times during the period under review to discuss the Internal Audit Charter and the internal audit work plan for 2013.

During the period October to December 2012 the organisation was in a process of start-up and no internal audit report was available.

3.4 Treasury audit

The Board of Auditors has requested a treasury audit, which will be carried out in 2013.

3.5 Board of Auditors' limited review

The Board of Auditors has made a start on a first inventory of the ESM's risk management architecture, its operating system, risk management ownership, delegation risk and end responsibility. It will pursue this topic in the year to come together with the ESM management.

The Board of Auditors carried out a limited review during April 2013 in accordance with Article 30(3) of the ESM Treaty. In line with Article 24(5) of the ESM By-Laws, the Board of Auditors appointed subject matter experts to support the audit work (audit team). The findings, which have been discussed with ESM management, are as follows:

- The external auditors' terms of reference are predicated on the standard external audit rules for short-form reporting. Consideration should be given to expanding the audit frame of reference, account being taken of the nature of the ESM as an important public-interest entity, so as to include a long-form reporting mandate inclusive of a comprehensive risk management assessment. The ESM management has replied that it does not support this recommendation and feels that this issue should be discussed with the Board of Governors.

- It is essential that, for accounting and reporting (managerial as well as financial) purposes, the ESM complete an internal accounting manual. The ESM management has replied that this is one of the priorities for the ESM's finance and control function and that an accounting manual is expected to be available by the end of the third quarter of 2013.

- The supporting evidence and procedures for the approval of external services through the EFSF were inadequate; the procedures need to be strengthened and documented. Invoices should indicate the services provided and give a detailed breakdown of the time spent on the project. The internal control of invoices should be strengthened. The ESM management has replied that there is room for enhanced controls over external providers.

3.6 Subsequent events

The Board of Auditors has exchanged views with the ESM management on issues and developments during the period from 1 January 2013 to 30 May 2013. The Board of Auditors has also discussed subsequent events with the ESM external auditor.

Based on the knowledge obtained from exchanges of views with the ESM management and external auditors, and on information in the public domain, the Board of Auditors is not aware of any significant subsequent events that should have been recognised in the ESM financial statements for the period from 8 October 2012 to 31 December 2012.

4. The way forward

During the period under review, since the Board of Auditors was itself in a process of start-up, it concentrated primarily on financial reporting and auditing issues and on building its own infrastructure, rules and procedures. It now plans to shift its focus to address also the broader issues of governance, risk management, the substance and implementation of financial policies, efficiency and effectiveness.

5. In closing

The ESM, for the period under review, was in a start-up phase. The Board of Auditors understands the strong commitment towards a "lean organisation" governance model. Nevertheless, the Board of Auditors encourages the Board of Governors to consider the potential risks associated with internal controls which are only partially operational.

The ESM was constituted as an international organisation, which gives it, in principle, a free hand in deciding its own legal and regulatory frame of reference. The Board of Auditors is of the opinion that it would serve the interest of the governing bodies of the institution, and provide clarity to all other stakeholders, if the ESM were to adopt a cohesive regulatory framework for its key operating functions. In view of the genesis of the ESM, its mandate, its position at the heart of the EU and the need for a generally-accepted, internally-cohesive regulatory framework, the Board of Auditors strongly recommends that the ESM adopt the EU regulatory framework as its own.

As its accounting framework, the ESM has decided to apply the general principles of the Fourth Council Directive 78/660/EEC of 25 July 1978, as amended, on the annual accounts

of certain types of companies, and Council Directive 86/635/EEC of 8 December 1986, as amended, on the annual accounts and consolidated accounts of banks and other financial institutions. The Board of Auditors recommends that the Management Board and the Board of Directors continuously monitor whether the accounting framework adopted is “fit for purpose” in the light of the ESM’s position as a high-profile public-interest organisation operating on financial markets.

The Board of Governors is invited to consider these findings and recommendations and undertake the appropriate initiatives.

Luxembourg, 30 May 2013

Board of Auditors